2009

Fiscal policy and private saving in Australia: Ricardian equivalence, twin deficits and broader policy inferences

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FISCAL POLICY AND PRIVATE SAVING IN AUSTRALIA: RICARDIAN EQUIVALENCE, TWIN DEFICITS AND BROADER POLICY INFERENCES

A thesis submitted in fulfilment of the requirements
for the award of the degree

Doctor of Philosophy

University of Wollongong
School of Economics
Faculty of Commerce
New South Wales, Australia

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October 2009

CERTIFICATION

I, Shane Anthony Brittle, declare that this thesis, submitted in fulfilment of the requirements for the award of Doctor of Philosophy, in the School of Economics, Faculty of Commerce, University of Wollongong, is wholly my own work unless otherwise referenced or acknowledged. The document has not been submitted for qualifications at any other academic institution.

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October 2009

ABSTRACT

Concern in the United States over fiscal and current account deficits during the 1980s led to arguments that these deficits were linked, or “twins”. The Reagan Administration conducted an expansionary fiscal policy by cutting taxes, which was not accommodated by monetary policy. This placed upward pressure on US interest rates – which subsequently boosted the US dollar. The exchange rate appreciation led to a fall in net exports and a rise in the US current account deficit. Under these circumstances, the current account appeared to mirror the fiscal position, leading to the popularisation of the twin deficits hypothesis.

Similar concerns were also held in Australia. Following the depreciation of the Australian dollar after its float in December 1983, the remainder of the decade saw a widening of the current account deficit; while net foreign debt increased from around 6 per cent of GDP in June 1981 to 32 per cent five years later. This led to both political and community unease over the large current account and rising stock of net foreign debt. Policymakers subsequently focused on fiscal consolidation as a means of reducing the current account deficit – leading to the establishment of policies such as the trilogy commitments in the Commonwealth’s 1985-86 Budget.

An antonym to the twin deficit argument is provided by Ricardian equivalence, which asserts that deficits merely postpone taxes, and through the actions of altruistically motivated individuals, budget deficits have no real affects on the economy – including the current account. Australian academics during the late 1980s and early 1990s such as Makin (1988), Pitchford (1989) and Corden (1991) also challenged the notion that Australia’s level of net foreign debt and the current account were concerns for fiscal policy. They argued that private sector investment and saving decisions were made by optimising private individuals and organisations, with any benefits or costs of these decisions being a matter for these private agents.

Research interest in fiscal policy waned over the 1990s, and for the most part of the 2000s, as monetary policy assumed the role of stabilising short-term fluctuations in prices and output in most advanced economies. Fiscal policy was left to focus upon the medium-term sustainability of government balance sheets, which for Australia

was reflected in the introduction of the *Charter of Budget Honesty Act* by the Howard Government, and the adoption of its medium-term fiscal strategy.

More recently, the sharp economic downturn associated with the global financial and economic crises of 2008 and 2009 has seen fiscal stimulus packages enacted in many countries, and a renewed interest in activist fiscal policy. With little empirical knowledge on the efficacy of fiscal policy in modern economies, recent discretionary fiscal policies have been enacted without a thorough understanding of the potency of these policy actions – particularly given the marked structural changes in many developed economies over the past two decades (such as the increased integration of global product and financial markets).

The purpose of this thesis is to provide an assessment of the potential efficacy of fiscal policy in Australia as a countercyclical policy tool. More specifically, the thesis considers whether private saving behaves in a manner that is consistent with Ricardian equivalence, thus mitigating the effects of fiscal policy, or conversely, if fiscal policy has some ability to influence real economic activity – leading to effects consistent with the twin deficits hypothesis.

This thesis seeks to make an original contribution to the literature by first considering a large sample, both in the number of observations (188), and across almost 50 years from 1959-2006. Second, a great deal of attention is given to structural change in the Australian economy over this time – something which previous empirical literature (particularly for Australia) has paid little attention to. Econometric techniques that consider the possibility of two structural breaks in each time series will be utilised. Incorporating these structural breaks into a cointegration analysis will allow for the estimation of such a large sample. Further, the work conducted here provides a more up-to-date analysis of the efficacy of fiscal policy in Australia. As noted by Kennedy (et al: 2004), there is little empirical evidence on the efficacy of fiscal policy in Australia, or estimates of fiscal multipliers.

The analytical model employed in this thesis considers the extent to which private saving responds to changes in the total general government (Commonwealth, state and local) fiscal stance. While this framework lends itself towards explaining

Ricardian equivalence effects, it can also be considered as a broad measure of the impact of fiscal policy on short- and long-run aggregate demand. The model is estimated using the autoregressive distributed lag approach (ARDL) to cointegration, which provides both short- and long-run coefficient estimates, but also provides the flexibility to accommodate the introduction of coefficients for structural breaks.

As mentioned above, it is likely that the Australian economy has been subject to a substantial amount of structural change over the past 50 years. From the 1950s through to the early 1980s, the economy was heavily regulated, with markets subject to price controls and tariff protection, a fixed exchange rate, and government controls on bank deposits, interest rates and credit. The 1980s saw a period of rapid reform, with the floating of the dollar, removal of restrictions on credit creation, interest rates, foreign capital inflows and other broader reforms around market pricing and removal (or lowering) of tariffs and subsidies. Not accounting for these changes could lead to spurious results in the econometric analysis. While traditional Augmented Dickey-Fuller tests are conducted, the more advanced Lee and Strazicich one and two-break unit root tests are also used – which will also yield information regarding the timing of structural breaks in the Australian economy.

Results indicate that while there is not a full Ricardian response to changes in the fiscal stance, there is some partial offsetting behaviour. The results imply that fiscal policy does elicit some impact on the real economy which will be partly offset by increased private saving or other crowding out effects. Lower short-run private saving offsets revealed through the error correction mechanisms indicate that nominal and real frictions and/or rigidities prevent some proportion of any offsetting savings behaviour occurring more quickly. Additionally, some households may also be subject to short-run liquidity constraints. However, nominal and real rigidities appear to have lessened as the Australian economy has been subject to significant economic reform.

ACKNOWLEDGEMENTS

My greatest thanks are reserved for my PhD supervisors, Associate Professor Nelson Perera and Associate Professor Ed Wilson. You have both been patient with my progress in completing this thesis, and I am extremely thankful for the assistance and advice that you have provided to me. I hope that the experience has been one where I have also contributed new information and understanding into the Australian economy and macroeconomic policy. I look forward to working with you on other projects in the future.

I would like to thank the Commonwealth Treasury, which has provided both financial assistance for my PhD studies, and the flexibility to take leave in order to complete major parts of this thesis. I am grateful to my colleagues in the Macroeconomic Policy Division for providing useful insights into fiscal policy and the Australian economy, and with the opportunity to work on projects that have had direct relevance to this thesis. I would also like to thank Tony McDonald for prompting me to pay some attention to the economic concept and statistical measurement of saving.

I would also like to thank staff and participants in the International Monetary Fund's workshops on fiscal policy (Fiscal Policy: Fiscal Discipline, Institutional Considerations, and Public Investment) held in Washington D.C. over November 2007. These workshops enhanced my understanding of contemporary fiscal policy issues – greatly benefiting the preparation of this thesis. Advice provided by David Hauner (IMF Fiscal Affairs Department) on measuring financial openness was also extremely helpful.

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